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Economy Hammered by Toxic Blend of Ailments

By Vikas Bajaj

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Almost everything seems to be going wrong for the American economy at once. People are buying less, but most things are costing more. Mortgage rates are rising, the dollar is falling and prices of key commodities like oil are leaping from one record high to the next.

On Thursday, the dollar plumbed new lows against the Japanese yen and several other major currencies; the price of an ounce of gold jumped above $1,000 for the first time; and lenders raised home loan rates once again. Government figures showed retail sales fell in February as consumers cut back on cars, furniture and electronics.

Stocks fell sharply after the retail sales report was released early in the day, and a large investment fund said it was nearing collapse. The volatility that has defined the market lately continued unabated.

The Standard & Poor's 500-stock index fell 2 percent in the morning, then rebounded partly in reaction to a report that said banks were nearing the end of subprime mortgage losses. It was up nearly 1 percent in the afternoon before paring that gain to close up 0.5 percent, to 1,315.48 points. The Dow Jones industrial average closed up 35.5 points, to 12,145.74 points.

A toxic blend of economic and financial developments is testing policy makers and lawmakers who are struggling to contain the slump brought on by the collapse of the mortgage market, a downturn that now looks sure to push the economy into a recession. Though current conditions are a far cry from the 1970s, resurgent inflation is raising the threat of stagflation — a condition in which unemployment and the price of goods and services both rise.

Since the credit markets began to seize up in August, the steps taken by the Federal Reserve and the rest of the federal government have often bolstered stocks briefly, but so far they have done little to stem the larger downward drift.

Many specialists say policy makers can do only so much to protect the economy and warn that the government should be careful not to exacerbate inflation and create a new bubble like the one in housing that has burst. Lower interest rates and increased federal spending may not be enough to shore up growth, and some suggest that the only remedy for the pain may be the pain itself. A Standard & Poor's report predicted that subprime mortgage write-downs at banks were nearly done, though losses in other areas might continue.

"We have to be careful about what medicines we throw at this, whether it's stimulus packages or a bailout," said Liz Ann Sonders, chief investment strategist at Charles Schwab & Company. "A lot of what we are dealing with is a solvency problem. We need to let the system wash it out."

By this way of thinking, the markets will eventually correct themselves. The housing and mortgage markets will pick up once home prices have fallen far enough to attract buyers. The dollar will keep falling until the weaker exchange rate increases American exports and, in turn, the broader economy.

Stocks and bonds will decline until weaker players who rely heavily on borrowed money are driven out of the markets, allowing those who were more conservative to invest cheaply.

"It's not a silver lining; it's a platinum lining," Carl B. Weinberg, chief economist at High Frequency Economics, said about the falling dollar and exports.

In the past 12 months, the dollar has slid nearly 14 percent against six major world currencies, reaching its lowest levels since the American exchange rate was allowed to float freely in the 1970s. Exports in January, by comparison, were up 16.3 percent from a year earlier; imports were up 10.9 percent.

On Thursday, one dollar fetched 100.69 yen, the lowest level since the mid-1990s and down 13.4 percent over the last year. The dollar has slipped 8.4 percent against the Chinese yuan and 18.4 percent against the euro.

The fall of the dollar has contributed to the surge in commodity prices, many specialists say. Oil, foodstuffs and many other raw materials are priced in dollars, and as the currency falls in value, suppliers of these commodities demand higher prices just to stay even.

The weakness of the dollar partly explains why oil prices have jumped $23 a barrel in the past six weeks alone. Oil futures touched $111 a barrel for the first time on Thursday and settled at $110.33 a barrel on the New York Mercantile Exchange, up 41 cents. Gold prices surged past $1,000 a troy ounce but closed at $993.80, up 1.4 percent for the day.

“Where do you go?” said John Kilduff, senior vice president for energy at MF Global in New York. “Where do investors go? Obviously, they are fleeing the dollar and seeking out hard assets like commodities. And that’s pushing up oil prices.”

For American consumers, the surge in commodity prices comes on top of falling home prices, tightening credit conditions and, lately, a weakening job market. The national average 30-year fixed mortgage rate climbed to 6.13 percent on Thursday, from 6.03 percent a week earlier, according to Freddie Mac. The rate on five-year adjustable rate loans jumped to 5.58 percent, from 5.34 percent.

It is no wonder, economists say, that retail sales and other measures of consumer spending are falling.

“We are nearing levels where it’s probably not a great thing for the dollar to keep weakening,” said David Gilmore, a partner at Foreign Exchange Analytics in Essex, Conn.

The Federal Reserve’s decisions to cut short-term interest rates to 3 percent, from 5.25 percent last year, is one of the biggest factors driving the dollar lower, experts say. Interest rates in Europe and much of Asia are higher, drawing investors to those currencies.

Policy makers at the Fed have acknowledged concerns about the dollar and inflation but have stressed that they are far more worried about a significant slowdown in economic growth. Ben S. Bernanke, the chairman of the Fed, will give a speech Friday in Washington in which he is expected to provide an update on the central bank's thinking. The Fed is widely expected to reduce interest rates again next week.

The Fed is in an unenviable position. Even as it has to guard against inflation, parts of the financial system are under severe pressure.

On Thursday, Carlyle Capital, an affiliate of the private equity firm the Carlyle Group, said that its negotiations with lenders had broken down and that it was in default on $16.6 billion in loans. Carlyle had borrowed the money to buy mortgage securities backed by Fannie Mae and Freddie Mac. All appeared well until the prices of those bonds declined and the lenders made a margin call — a demand that Carlyle put up more collateral to cover the loans.

Andrew Feltus, a bond fund manager at Pioneer Investments in Boston, said the banks were reducing the amount of money they lend to the financial system. Few investors want to buy in the middle of this process, because they expect even lower prices as funds are forced to sell.

"You have not seen the rush to risk at all," he said. "People are still scared."

Anthony Lembke, a portfolio manager at MKP Capital Management, a hedge fund, said one of the biggest uncertainties in the bond market is the size of the losses in mortgage securities. Banks and investors are both expected to remain jittery, even about safer investments, until they have a firmer answer.

"We have got to get to the bottom of the housing market," he said, "before we know how big the losses are going to be."

Bond prices fell as stocks rose Thursday. The benchmark 10-year Treasury note dropped 16/32, to 99 25/32. The yield, which moves in the opposite direction, rose to 3.53 percent, from 3.46 percent.